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This memorandum is in response to your request for informal technical assistance with regard to the appropriate treatment under sections 901 and 902 of the Internal Revenue Code of tax payments made by [REDACTED] and/or its subsidiaries (hereinafter "[REDACTED]") to the Brazilian government.

You have supplied us with copies of both the International Examiner's Report and [REDACTED]'s protest letter involving Brazilian foreign tax credit issues. You have asked us for arguments in support of the Service's position that the excess cruzeiros [REDACTED] paid to the Brazilian government as a monetary correction to their tax liabilities are not creditable for purposes of sections 901 and 902 of the Internal Revenue Code.

Essentially, the following is our argument. During the 1980s, the currency in Brazil was deflating in value so rapidly that it became worthless as a reliable measure of economic exchange. All bona fide commercial, financial and taxation transactions were indexed for inflation in order to infuse them with economic meaning. The index, the Readjustable National Treasury Bond (ORTN), replaced the currency as the meaningful measure of economic value. The ORTN (which was revalued and renamed the "OTN" in 1986) was first introduced by Law 4.357 in 1964. The ORTN was a bond worth Cr\$10,00 when introduced. The number of cruzeiros to the ORTN was determined monthly by the Brazilian government according to official inflation indices. In this sense, the ORTN is analogous to our post-1986 concept of a functional currency as set forth in section 985 of the Internal Revenue Code.

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In a 1989 opinion, the Tax Court made certain findings of facts regarding the hyperinflation in Brazil and its effect on commercial transactions. Agro Science Company v. Commissioner, 1989 T.C.Memo 687, aff'd 927 F.2d 213 (5th Cir. 1991), rev. denied U.S. S.Ct. (October 15, 1991). The Agro Science case involved an investment entered into in 1982 by certain United States taxpayers who included in their tax bases certain notes payable in Brazilian cruzeiros, which notes carried a 10 percent interest rate but were not indexed for inflation. The Tax Court found that the notes were shams for tax purposes because they were not indexed for inflation. Significantly, in Agro Science the Tax Court found that it was an unreasonable business practice in Brazil not to index commercial transactions for inflation:

In 1982 when [the taxpayers formed certain partnerships and entered into long-term debt denominated in cruzeiros], Brazilian currency was undergoing hyper-inflation and devaluation against the dollar. From 1974 to 1978, inflation in Brazil averaged 38 percent annually. The rate reached 77.2 percent in 1979, 110.2 percent in 1980, 95.2 percent in 1981, and 99.7 percent in 1982 . . . .

Over the decade ending in 1982, both interest rates and the exchange rate of cruzeiros/dollars in Brazil tended to rise with inflation.[footnote omitted] In 1982 investment banks were lending money at 8.5 percent monthly, or 166 percent per annum. Automobile purchasers paid interest up to 9.2 percent monthly or 197 percent annually. Depositors in the Letra de Cambio were receiving 7.25 percent monthly on their deposits during the first week of December 1982 while bank certificates of deposit were paying 7.6 percent monthly or 140 percent per annum. After years of high inflation, the standard practice in Brazil for all but very short-term debt was to incorporate monetary correction or indexation clauses into financial contracts. Making long-term loans in cruzeiros with nominal interest rates and no monetary correction or indexation clause like the [notes that the taxpayers executed] was not a normal business practice for transactions in 1982.

Subsequent to 1982, inflation was far worse than predicted in December of 1982. Brazil's inflation rose to the range of 210-235 percent annually in 1983-1985 while the interest rates and cruzeiro/dollar exchange rate increased accordingly.[footnote omitted] In 1986 the Brazilian government launched the Cruzado Plan replacing the cruzeiros with the cruzado at 1,000 to one and freezing all prices and wages to halt inflation in Brazil. The result was an annual inflation rate of about 65 percent through 1986 and serious product shortages, excess demand, and a large fiscal deficit. The annual inflation rate soared to over 1,000

percent in the early months of 1987. By the end of 1987, inflation had receded to its normal monthly rate of about 10 percent.

As the Agro Science case demonstrates, the cruzeiro (later cruzado) became valueless for commercial purposes. For example, as the Agro Science case found, and which finding was upheld on appeal, a long-term debt in the amount of NCr\$130,305,000 in 1982, or \$525,000, could be paid off in 1988 for approximately \$182.

Not only were commercial transactions indexed for inflation, but financial statements, which recap commercial transactions, were required by law to be indexed for inflation. In addition, many legal entities whose net worth exceeds a certain cruzado amount are required by law to maintain an auxiliary record in which the assets, liabilities and net worth values required to be adjusted are expressed, not in the local currency, but in the number of OTNs representing their true value. Other taxpayers who must adjust their accounts for inflation may choose to maintain the auxiliary record or to adjust the number of cruzeiros shown on their accounts in accordance with the changing value of the OTN. Significantly, the adjustments for inflation required by law for financial statements were taken into account for tax purposes as well.

In addition to commercial transactions and financial statements, tax liability itself was expressed in ORTNs because of the negative impact that hyperinflation was having on the Brazilian fisc. Brazilian Decree Law No. 1967 (the Decree Law), effective as of November 23, 1982, provided for the indexation of income tax installment payments. This system of indexation was effective until March of 1986 at which time the cruzado was introduced and all prices were frozen for one year. Hyperinflation persisted and tax payments were again indexed for inflation.

Under the Decree Law, taxable income as stated in cruzeiros was converted into the equivalent number of ORTNs, based upon number of cruzeiros to the ORTN in the month following the end of the taxable year. The taxable income as expressed in ORTNs was then multiplied by the appropriate tax rate to arrive at the tax liability in ORTNs.

In Rev. Rul. 91-21, 1991-11 I.R.B. 5 (March 18, 1991), the Service ruled that the ORTN tax liability is "foreign taxes paid" for purposes of sections 901 and 902 of the Code. In other words, the ORTN tax liability, as provided by law and as shown on the Brazilian corporation's tax return, provides the basis for the multiplicand of the section 902 equation as well as the foreign taxes paid for purposes of expressing the denominator as

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accumulated profits less foreign taxes paid.

If you need further assistance on this matter, please  
contact Mr. Lundeen at FTS 566-6645.

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